

10-1-1996

## Check Encoding Warranties Under Revised Uniform Commercial Code Article 4 and Regulation CC

W. David East

Follow this and additional works at: <https://repository.law.miami.edu/umlr>

---

### Recommended Citation

W. David East, *Check Encoding Warranties Under Revised Uniform Commercial Code Article 4 and Regulation CC*, 51 U. Miami L. Rev. 97 (1996)

Available at: <https://repository.law.miami.edu/umlr/vol51/iss1/4>

This Article is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact [library@law.miami.edu](mailto:library@law.miami.edu).

# Check Encoding Warranties Under Revised Uniform Commercial Code Article 4 and Regulation CC

W. DAVID EAST\*

I. INTRODUCTION .....	97
II. U.C.C. § 4-209 ENCODING WARRANTY .....	99
A. <i>Who Makes the Warranty?</i> .....	99
B. <i>To Whom Is the Warranty Made?</i> .....	99
C. <i>What Does the Warranty Cover?</i> .....	100
D. <i>What Damages Are Recoverable?</i> .....	100
1. REQUIREMENT OF GOOD FAITH .....	101
2. OVERENCODING .....	102
3. UNDERENCODING .....	107
a. Recourse to the Drawer's Account .....	108
b. Setoff Against Other Accounts of the Drawer .....	110
E. <i>Is Subrogation Available as a Defense to Either the Payor Bank or the         Depository Bank?</i> .....	115
III. REGULATION CC § 229.34 ENCODING WARRANTY .....	118
A. <i>Who Makes the Warranty?</i> .....	118
B. <i>To Whom Is the Warranty Made?</i> .....	118
C. <i>What Does the Warranty Cover?</i> .....	119
D. <i>What Damages Are Recoverable?</i> .....	119
E. <i>How Are Damages Recovered in Cases of Overencoding?</i> .....	122
F. <i>Procedure in Cases of Underencoding</i> .....	123
G. <i>Application to Return Items</i> .....	123
IV. HOW MUCH OF U.C.C. § 4-209 IS PREEMPTED? .....	124
A. <i>Preemption in General</i> .....	124
B. <i>Extent of Preemption of U.C.C. § 4-209 by Regulation CC</i> .....	126

## I. INTRODUCTION

Uniform Commercial Code Article 4-Bank Deposits and Collections, as originally promulgated in 1951, was designed for a system in which depository and payor banks processed paper checks and items by hand.<sup>1</sup> Today revolutionary Magnetic Ink Character Recognition ("MICR") technology permits the electronic reading and mechanical processing of checks. With over fifty-five billion checks processed each

---

\* Professor of Law, South Texas College of Law; B.A., 1971 Baylor University; J.D.(cum laude), 1973, Baylor University School of Law; LL.M., 1978, George Washington University National Law Center. The author would like to acknowledge and thank Ms. Shelly Liebham, J.D. (summa cum laude), 1994, South Texas College of Law, for her research and drafting assistance. Professor Randall Kelso and Assistant Professor Timothy Zinnecker, the author's colleagues at South Texas College of Law, read drafts of this Article and provided excellent substantive and editorial comments. The author expresses his appreciation to them while reserving to himself responsibility for any errors readers may discover.

1. See U.C.C. art. 3 prefatory note (1990).

year,<sup>2</sup> the need for this sophisticated and automated mechanism is readily apparent. MICR symbols printed (encoded) in special ink at the bottom of the checks allow reader-sorter machines to process checks up to an incredible rate of 120,000 items per hour—a vast improvement over processing items by hand.<sup>3</sup> The MICR line on a check contains three different “fields,” locations, where the necessary information is encoded. The first field is in the bottom left portion of the check and gives the routing information, which basically tells the reader-sorter machines of depository and collecting banks where to send the check.<sup>4</sup> The second field is located in the middle portion of the MICR line and contains the drawer’s account number at the payor bank and the check number.<sup>5</sup> Finally, the amount field is in the right-hand bottom portion of the check.<sup>6</sup> A financial institution prints the routing information and the account and check numbers (the first and second fields) on the check before furnishing it to its customer.<sup>7</sup> The depository bank usually encodes the amount of the check after the payee has either deposited the check into his or her account or received payment over the counter for the check.<sup>8</sup> After the depository bank encodes the amount, it then sends the check through the forward collection process to the payor bank, which then either pays or dishonors the item.<sup>9</sup> Once the amount is encoded, in most cases, no person examines the item any further.<sup>10</sup>

The encoding of the amount of the check is the main focus of this Article. Although the possibility of encoding error exists for any portion of the MICR line, encoding error is especially likely to occur in the amount field. To deal with problems associated with the losses that result from overencoding and underencoding, in 1990 the drafters of the Uniform Commercial Code added an encoding warranty for persons who do the actual encoding.<sup>11</sup> This warranty basically states that any

---

2. See James L. Turgal, *The Need for Speed: Who Should Bear the Financial Responsibility for Magnetic Ink Encoding Errors and the Future of Check Processing Technology?*, 97 COM. L.J. 410, 413 (1992).

3. See *id.*

4. See JAMES F. DOLAN, *UNIFORM COMMERCIAL CODE: TERMS & TRANSACTIONS IN COMMERCIAL LAW* § 23.1 (1991).

5. See *id.*

6. See *id.* § 23.2.

7. See *id.* § 23.1.

8. See *id.* § 23.2. Sometimes the encoding is done by bank customers who are payees of large volumes of checks. See *infra* note 12.

9. The forward collection process is described in DOLAN, *supra* note 4, §§ 23.2-7. Typically the depository bank sends the check through a Federal Reserve Bank or through a clearinghouse to be presented to the payor bank.

10. See TURGAL, *supra* note 2, at 411.

11. U.C.C. § 4-209 (1990). In 1990 a number of amendments were made to Articles 3 and 4 of the Uniform Commercial Code. These versions of amended articles 3 and 4 will be referred to as “Revised Article 3” and “Revised Article 4,” respectively. Unless otherwise indicated,

person who encodes information on checks warrants that the encoded information is correct.<sup>12</sup> On January 3, 1994, the Federal Reserve Board promulgated a revision to Regulation CC, 12 C.F.R. § 229, which also covered encoding warranties.<sup>13</sup> This Article will discuss the specific provisions of each warranty individually and will compare and contrast overlapping areas of the two warranties. Finally, the extent to which Regulation CC preempts Article 4 will be discussed, culminating in a suggestion of the ways in which these warranties coexist.

## II. U.C.C. § 4-209 ENCODING WARRANTY

### A. *Who Makes the Warranty?*

The encoding warranty under section 4-209 covers "a person who encodes."<sup>14</sup> Most often this will be the depository bank. However, some bank customers—especially those who process a large volume of checks—will do their own encoding.<sup>15</sup> When this occurs, both the customer who did the actual encoding and the depository bank make the warranty.<sup>16</sup>

### B. *To Whom Is the Warranty Made?*

The warranty is made "to any subsequent collecting bank and to the payor bank or other payor."<sup>17</sup> Thus, banks included in the forward col-

---

references in this Article to sections under Articles 3 and 4 are to Revised Articles 3 and 4. Any references to "Pre-revised Article 3" or "Pre-revised Article 4" refer to the Articles as they existed prior to the 1990 amendments.

12. The UCC encoding warranty is found in § 4-209, which reads:

(a) A person who encodes information on or with respect to an item after issue warrants to any subsequent collecting bank and to the payor bank or other payor that the information is correctly encoded. If the customer of a depository bank encodes, that bank also makes the warranty.

(b) A person who undertakes to retain an item pursuant to an agreement for electronic presentment warrants to any subsequent collecting bank and to the payor bank or other payor that retention and presentment of the item comply with the agreement. If a customer of a depository bank undertakes to retain an item, that bank also makes this warranty.

(c) A person to whom warranties are made under this section and who took the item in good faith may recover from the warrantor as damages for breach of warranty an amount equal to the loss suffered as a result of the breach, plus expenses and loss of interest incurred as a result of the breach.

*Id.*

13. 12 C.F.R. § 229.34(c); *see also infra* note 143 for the text of the warranty.

14. U.C.C. § 4-209(a) (1990). "Person" includes an individual or an organization. U.C.C. § 1-201(30). "Organization" includes a "corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity." *Id.* § 1-201(28).

15. *See id.* § 4-209, cmt. 1.

16. *See id.* § 4-209(a).

17. *Id.*

lection process, payor banks, and non-bank payors, such as insurance companies issuing "payable through" drafts, benefit from the warranty.<sup>18</sup>

### C. *What Does the Warranty Cover?*

Simply stated, the warranty provides that any information encoded on the check by the person making the warranty has been correctly encoded.<sup>19</sup> Although the main focus of this Article is the warranty as it relates to the amount field, the warranty covers all entries made by the warrantor on the MICR line as well. For instance, an error in the routing number, whether the result of fraud or mistake, presumably would lead to breach of the encoding warranty under section 4-209 of the UCC, as this number would be considered encoded "information." In addition, when an original check is damaged, incorrect, or unreadable, a depository bank or other collecting bank may re-encode the full MICR line on a strip of paper, which is then attached to the bottom of the check ("strip skirting"). The encoding warranty would apply in this situation as well. It is important to emphasize, however, that a person who encodes only warrants the correctness of the information that person encoded, not information that was previously encoded by another person.<sup>20</sup>

### D. *What Damages are Recoverable?*

Section 4-209(c) of the UCC provides:

A person to whom warranties are made under this section and who took the item in good faith may recover from the warrantor as damages for breach of warranty an *amount equal to the loss suffered as a result of the breach*, plus expenses and loss of interest incurred as a result of the breach.<sup>21</sup>

Although there is no direct case authority on the extent of damages recoverable, what follows is a discussion on the issues that may arise in applying the damages provision of the encoding warranty, and suggestions on how courts could analyze these issues to arrive at a conclusion that is in harmony with the spirit of the Uniform Commercial Code.

---

18. See U.C.C. § 3-120 cmt. (pre-revised), reprinted in 4 WILLIAM D. HAWKLAND & LARY LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 3-120, at 270 (1994); U.C.C. § 4-106(a) (1990).

19. See U.C.C. § 4-209(a) (1990).

20. If the the depository bank's customer does the encoding, the depository bank makes the warranty as well as the customer. See *supra* Part II.A. By contrast, the encoding warranty under Regulation CC, 12 C.F.R. § 229.34(c)(3), includes a warranty by intermediary banks that information previously encoded by others is accurate. See *infra* notes 143-45 and accompanying text.

21. U.C.C. § 4-209(c) (1990) (emphasis added).

## 1. REQUIREMENT OF GOOD FAITH

To recover damages for breach of the encoding warranty, the person claiming the benefit of the warranty must have taken the item in good faith.<sup>22</sup> Article 4 applies the Article 3 definition of good faith.<sup>23</sup> Article 3 defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."<sup>24</sup> This two-part definition includes both a subjective and an objective component. The subjective component—honesty in fact—corresponds to the definition of good faith found under section 1-201(19),<sup>25</sup> which was also the definition of good faith that applied to pre-revised Articles 3 and 4.<sup>26</sup> Comment 4 to section 3-103 states that the objective requirement of fair dealing includes the "observance of reasonable commercial standards."<sup>27</sup> The comment goes on to state that this standard actually deals with the *fairness* of the conduct, rather than with the exercise of ordinary care.<sup>28</sup>

Section 4-209's good faith requirement should not be difficult for any potential beneficiary to meet. The subjective portion of the good faith requirement is satisfied as long as the beneficiary was not dishonest.<sup>29</sup> The objective prong of the good faith requirement is apparently met if the bank acted in a manner considered commercially fair in its business. Only time will tell what type of conduct would not satisfy that requirement.<sup>30</sup>

---

22. See *id.* There is no corresponding requirement expressly stated in Regulation CC, 12 C.F.R. § 229.34(c). See *infra* note 158 and accompanying text.

23. See U.C.C. § 4-104(c) (1990).

24. *Id.* § 3-103(a)(4).

25. "'Good faith' means honesty in fact in the conduct or transaction concerned." *Id.* § 1-201(19).

26. See *id.* § 3-103, cmt. 4.

27. *Id.*

28. See *id.*; see also *Arrow Indus. v. Zions First Nat'l Bank*, 767 P.2d 935, 938 (Utah 1988) (stating that a bank's duty to act in good faith "appeals to our sense of reason and fairness and best comports with the UCC's stated purposes, policies, and rules of construction"). One commentator has described this standard by stating that "a party must not attempt to exceed the bounds of fair conduct as defined by his profession or business." 6 WILLIAM D. HAWKLAND & LARY LAWRENCE, *UNIFORM COMMERCIAL CODE SERIES [REV]* § 3-103:05 (1993).

29. One situation where a lack of subjective good faith should be found is where the beneficiary payor/bank and its customer/drawer are attempting to defraud the encoding party who underencoded the drawer's check.

30. Compare WILLIAM EVERETT BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* § 101 (2d ed. 1961), where Professor Britton comments on the bad faith rule of the Uniform Negotiable Instruments Law: "If some court could write an opinion which would tell an inquirer how the bad faith rule will actually work under variable facts, so accurately that results could be predicted with certainty, much litigation would be forestalled and much wear and tear on the nervous system, as well as upon law libraries, would be avoided."

## 2. OVERENCODING

To facilitate the discussion of damages recoverable under Section 4-209, consider the following hypothetical.<sup>31</sup> Suppose drawer writes a check payable to the payee for \$2500. The payee takes the check to her bank and deposits it into her account. Depositary bank then misencodes the amount field on the MICR line of the check in the amount of \$25,000 and sends the check through the forward collection chain to the payor bank. The payor bank then pays the item and takes \$25,000 out of the drawer's account, rather than the correct amount, \$2500. This additional debit to the drawer's account causes the account to have insufficient funds when subsequent checks are presented for payment to the payor bank. The payor bank dishonors the subsequent checks and sends them back through the return chain to the various depositary banks.<sup>32</sup>

The initial question to ask is whether the dishonor of the subsequent checks is a wrongful dishonor. Wrongful dishonor occurs when a payor bank dishonors a properly payable item.<sup>33</sup> If the subsequently

---

31. This hypothetical is taken directly from Official Comment 2, U.C.C. § 4-209 (1990).

32. Although this hypothetical is taken from the Official Comment, this situation would actually be unusual. In the vast majority of banks, the computerized machines that process checks sort out items as large as \$25,000 for signature verification. *See, e.g., Wilder Binding Co. v. Oak Park Trust and Savings Bank*, 552 N.E.2d 783, 785 (Ill. 1990) (where the bank's procedure was to examine items drawn for more than \$1000). The overencoding might be discovered at that time. If not, in addition to a cause of action for wrongful dishonor, as described below, the drawer/customer would have a potential action against its bank for negligence in not discovering the encoding mistake. *See* U.C.C. § 4-103(a) (1990) (stating that a bank may not disclaim responsibility for its failure to exercise ordinary care).

Another question is whether such negligence of the payor bank, if found, would be available as a defense—in the form of contributory or comparative negligence—in an action against the depositary encoding bank for breach of encoding warranty liability. The negligence discussed in this note would be common law negligence, rather than one of the specific situations dealt with in the UCC such as in section 3-406 (failure to exercise ordinary care which failure substantially contributes to the making of a forged signature or alteration). Negligence in failing to discover the overencoding upon examining the drawer's signature, however, would be available under section 1-103. *See infra* note 125; *cf. Girard Bank v. Mount Holly State Bank*, 474 F. Supp. 1225, 1239 (D.C.N.J. 1979) (holding that a common law negligence action is still available for the depositary bank suing the drawer). Such negligence should be available as a defense to the liability of the depositary bank for breaching the encoding warranty, because but for such negligence there would have been no overpayment from the drawer's account and no wrongful dishonor of checks.

33. *See* U.C.C. § 4-402(a) (1990). Section 4-402(a) states:

Except as otherwise provided in this Article, a payor bank wrongfully dishonors an item if it dishonors an item that is properly payable, but a bank may dishonor an item that would create an overdraft unless it has agreed to pay the overdraft.

*Id.* Section 4-401(a) describes when an item is properly payable:

A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.

*Id.* § 4-401(a); *see also* BARKLEY CLARK & BARBARA CLARK, *THE LAW OF BANK DEPOSITS*,

presented checks were otherwise properly payable, then a wrongful dishonor has occurred as to these checks.<sup>34</sup>

Once a wrongful dishonor occurs, the warranty beneficiary is entitled to damages.<sup>35</sup> The operative language in section 4-209 states that the warranty beneficiary may recover "an amount equal to the loss suffered as a result of the breach."<sup>36</sup> In the above example, this would certainly allow the payor bank to recover from the depositary bank any amount the payor bank paid out over the original \$2500.<sup>37</sup> But this quoted language also allows recovery for damages *beyond* the face amount of the item, so long as they were suffered *as a result* of the breach. Unlike damages recoverable for breach of a transfer warranty,<sup>38</sup> recovery is not limited to the amount of the item plus expenses and loss of interest.<sup>39</sup>

The first step in determining what is included as damages for breach of the encoding warranty under section 4-209 is to calculate what damages the payor bank has incurred. These damages primarily will be a result of the wrongful dishonor. Assume the same facts as the above hypothetical: the payor bank has debited the drawer's account \$22,500 more than it should have. Further assume that just before this overpayment, the drawer had an account balance of \$30,000. Subsequent checks totalling an additional \$10,000 are presented for payment to the payor bank.

If the misencoded check had been properly encoded by the depositary bank, the drawer would have had enough funds in the account to cover that check, as well as the subsequent checks. The payor bank would have paid the properly payable items and all would be well. However, since the depositary bank overencoded the check by \$22,500, the original \$30,000 balance was reduced to \$5000 (\$30,000 less \$25,000), which is insufficient to cover the \$10,000 in subsequent items. Because the \$5000 balance is insufficient to cover all of the subsequent items, some of these items will be wrongfully dishonored.<sup>40</sup> The payor bank will be liable to its customer for damages resulting from the

---

COLLECTIONS AND CREDIT CARDS ¶ 16.03[2] (rev. ed. 1995) (stating payor bank would be liable for wrongful dishonor in same situation even though depositary bank made the encoding error).

34. See U.C.C. § 4-402(a) (1990).

35. See *id.* § 4-209(c).

36. *Id.*

37. See *id.* § 4-209, cmt. 2. According to comment 2, because the depositary bank breached the encoding warranty, the payor bank could hold the depositary bank liable for this amount even without first pursuing the payee, who received a \$22,500 surplus as a result of the depositary bank's encoding error.

38. See *id.* § 4-207(c).

39. For a discussion of damages recoverable under U.C.C. § 4-207, see *infra* Part III.D.

40. See *supra* notes 33-34 and accompanying text.



wrongful dishonor.<sup>41</sup> Therefore the payor bank's damages are derivative of drawer's damages.

Suppose, on the other hand, that the drawer's account contains only \$20,000 when the overencoded check is presented. If the payor bank chooses to dishonor the check because of insufficient funds, it would be wrongfully dishonoring the check, and the drawer would have a claim against the payor bank.<sup>42</sup> As damages then, the payor bank would include a claim against it by the drawer for the wrongful dishonor.

Under section 4-402, damages recoverable for wrongful dishonor include damages proximately caused by the wrongful dishonor, as well as damages for arrest and prosecution.<sup>43</sup> This may include consequential damages.<sup>44</sup> The words "proximately caused" connote tort-like recovery. Cases decided under section 4-402 have allowed recovery for various types of tort-like damages, including damage to credit or business standing,<sup>45</sup> lost profits,<sup>46</sup> mental anguish,<sup>47</sup> and punitive damages.<sup>48</sup>

---

41. See U.C.C. § 4-402(b) (1990).

42. See *supra* notes 33-34 and accompanying text.

43. See U.C.C. § 4-402(b) (1990).

44. See *id.* But see *Donmoyer v. Columbus Bank & Trust Co.*, 258 S.E.2d 725, 727-28 (Ga. Ct. App. 1979) (denying recovery of consequential damages after wrongful dishonor because customer failed to mitigate damages).

45. See *Elizarraras v. Bank of El Paso*, 631 F.2d 366, 377 (5th Cir. 1980) (remanding case for new trial on issue of damages for loss of credit and reputation); *Fidelity Nat'l Bank v. Kneller*, 390 S.E.2d 55, 59 (Ga. Ct. App. 1989) (allowing damages for decline in corporation's business); *Loucks v. Albuquerque Nat'l Bank*, 418 P.2d 191, 198-99 (N.M. 1966) (holding evidence sufficient to raise question of fact as to whether damage to partnership's credit resulted from wrongful dishonor); *Farmers and Merchants State Bank v. Ferguson*, 617 S.W.2d 918, 921-22 (Tex. 1981) (affirming recovery for loss of credit); *American Bank v. Waco Airmotive, Inc.*, 818 S.W.2d 163, 174 (Tex. Ct. App. 1991) (allowing recovery for loss of credit if supported by evidence).

46. See *Fidelity Nat'l*, 390 S.E.2d at 59-60 (allowing loss of prospective profits as consequential damages).

47. See *Murdaugh Volkswagen, Inc. v. First Nat'l Bank*, 801 F.2d 719, 727 (4th Cir. 1986) (allowing recovery for defamation); *Twin City Bank v. Isaacs*, 672 S.W.2d 651, 655-56 (Ark. 1984) (holding mental anguish damages recoverable); *Kendall Yacht Corp. v. United Bank*, 123 Cal. Rptr. 848, 853 (Ct. App. 1975) (stating that cause of action for wrongful dishonor sounds in both contract and tort, and allowing recovery for emotional distress); *Farmers and Merchants State Bank*, 617 S.W.2d at 921 (holding that mental anguish damages are allowed under U.C.C. § 4-402). But see *Bank of Louisville Royal v. Sims*, 435 S.W.2d 57, 58 (Ky. Ct. App. 1968) (denying recovery for mental anguish damages based on "hurt feelings").

48. See *Twin City Bank*, 672 S.W.2d at 656 (upholding award of punitive damages as not excessive); *Fidelity Nat'l*, 390 S.E.2d at 60 (allowing recovery of punitive damages because wrongful dishonor sounds in tort as well as contract); *American Bank*, 818 S.W.2d at 176 (stating that punitive damages are available when bank acts with malice or in reckless disregard of its depositor's rights). But see *Loucks*, 418 P.2d at 199 (denying recovery of punitive damages based on insufficiency of evidence); *Kendall Yacht Corp.*, 123 Cal. Rptr. at 855 (disallowing punitive damages where plaintiff failed to show "evil motive" on part of bank). The last sentence of comment 1 to section 4-402 states: "Whether a bank is liable for noncompensatory damages, such as punitive damages, must be decided by Section 1-103 and Section 1-106 ('by other rule of

For example, in *American Bank of Waco v. Waco Airmotive, Inc.*,<sup>49</sup> American Bank exercised its right of setoff<sup>50</sup> against Waco Airmotive's checking account for delinquent payments on a bank loan.<sup>51</sup> This set-off—later found to be wrongful—lead to the subsequent dishonor of over \$15,000 worth of checks written on Waco Airmotive's account<sup>52</sup> and the cancellation of a contract with one of Waco Airmotive's suppliers.<sup>53</sup> Because the initial setoff was wrongful, the subsequent dishonor was also wrongful.<sup>54</sup> The Court of Appeals of Texas upheld an award of \$25,000 in damages for loss of credit<sup>55</sup> and allowed the recovery for punitive damages, holding that the bank "acted with malice or in reckless disregard of the rights of its depositor."<sup>56</sup>

In another case, *Twin City Bank v. Isaacs*,<sup>57</sup> a bank denied its customers access to their funds for over four years.<sup>58</sup> Because the bank froze the account, several of the customers' checks were dishonored.<sup>59</sup> The initial freezing of the account was not proper; therefore, the subsequent dishonors were wrongful.<sup>60</sup> The court stated: "Wrongful dishonors tend to produce intangible injuries similar to those involved in defamation actions."<sup>61</sup> In addition to affirming damages for the value of two repossessed vehicles, service charges, and overdraft fees, it also affirmed recovery for mental anguish.<sup>62</sup> The court allowed into evidence proof of the loss of the bargain on a house to show mental anguish.<sup>63</sup> This loss resulted from the wrongful dishonor of the earnest money check the customers wrote to purchase the house.<sup>64</sup>

As case law suggests, damages for wrongful dishonor include a

---

law').” U.C.C. § 4-402, cmt. 1 (1990). This substantiates the cited cases' conclusion that punitive damages should be recoverable in certain cases which are otherwise governed by the UCC.

49. 818 S.W.2d 163 (Tex. Ct. App. 1991).

50. For a discussion of a bank's right to offset (or setoff), see *infra* text accompanying notes 95-99.

51. See *American Bank*, 818 S.W.2d at 167.

52. See *id.*

53. See *id.* at 175.

54. See U.C.C. § 4-402 (1990).

55. See *American Bank*, 818 S.W.2d at 174.

56. *Id.* at 176.

57. 672 S.W.2d 651 (Ark. 1984).

58. See *id.* at 652.

59. See *id.*

60. See U.C.C. § 4-402 (1990).

61. *Twin City Bank*, 672 S.W.2d at 654.

62. See *id.* (citing *State Bank of Siloam Springs v. Marshall*, 260 S.W. 431 (Ark. 1924)). In *Twin City*, the customers were unable to secure credit at other institutions after the wrongful dishonors and had to resort to borrowing money from relatives and friends. See *id.* at 655. In addition, the financial problems resulting from the wrongful dishonors led to marital difficulties and the general anxieties which often accompany financial problems. See *id.*

63. See *id.*

64. See *id.*

variety of tort-like recoveries. Thus, if the payor bank in the above hypothetical subsequently dishonored \$5000 worth of the drawer's checks due to the overencoding, or if the payor bank dishonored the misencoded check due to insufficient funds, the drawer might suffer some form of consequential damages, such as loss of credit, lost profits, or mental anguish. In the typical wrongful dishonor situation, where the payor bank fails to honor properly payable items due to its own error, the payor bank would be liable under section 4-402 of the UCC for these damages. Does it follow then, that because the depository bank made the encoding error, thus breaching its encoding warranty, it should be responsible to the payor bank for these "loss[es] suffered as a result of the breach" under section 4-209 of the UCC?<sup>65</sup> Yes, holding the depository bank liable for damages incurred by the payor bank due to the depository bank's encoding error places the risk of loss on the party best able to prevent it, and, therefore, is in harmony with other Uniform Commercial Code provisions.<sup>66</sup> The depository bank, or its customer if the customer did the encoding, is in the best position to prevent the loss by properly encoding the item. Since the consequences of overencoding can be extreme, given the ability to recover damages such as mental anguish and lost profits, both common sense and fairness dictate that the depository bank should be held liable for its own error.

To summarize, when a depository bank overencodes, it breaches its encoding warranty and is liable to the payor bank and any subsequent collecting bank for losses suffered as a result of the breach. The language in section 4-209 suggests that the section 4-402 damages for which the payor bank becomes liable to the drawer are losses resulting from the breach. These losses may include anything from overdraft fees to lost profits and mental anguish. In addition, loss of interest is specifically recoverable under section 4-209 for breach of the encoding warranty.<sup>67</sup> It is doubtful, however, that punitive damages would be available against the payor bank since the wrongful dishonor occurred as a result of the encoding party's error, not from malice or willfulness on the part of the payor bank. If punitive damages are allowed, they should not be passed back to the misencoding party, since there was no willfulness or malice on the part of that party.<sup>68</sup>

---

65. U.C.C. § 4-209(c) (1990). For earlier commentary to the contrary, see HENRY J. BAILEY & RICHARD B. HAGEDORN, *BRADY ON CHECKS* ¶ 19.4 (cum. supp. no. 1 1992). Note that this commentary discusses pre-revised Article 4, which had no encoding warranty provision.

66. See *Hartford Accident & Indem. Co. v. American Express Co.*, 542 N.E.2d 1090, 1096 (N.Y. 1989) (citing Comment, *Allocation of Losses from Check Forgeries Under the Law of Negotiable Instruments and the Uniform Commercial Code*, 62 *YALE L.J.* 417 (1953)).

67. See U.C.C. § 4-209(c) (1990).

68. Of course, if the payor bank deliberately refuses to recredit the drawer's account after being made aware of the overencoding, that would be a separate basis for punitive damages.

## 3. UNDERENCODING

Here too it is helpful to begin with a hypothetical. Suppose the drawer writes a check for \$25,000, and the depositary bank erroneously encodes the check for \$2500<sup>69</sup> and sends the check through the forward collection chain to the payor bank. The payor bank pays the check by electronically reading the MICR line and thus takes only \$2500 out of the drawer's account. The payor bank would be liable for the full amount of the check,<sup>70</sup> because the payor bank has finally paid the item.<sup>71</sup> Although this result seems clear under the pre-revised Code,<sup>72</sup> it is less clear under the new Code.<sup>73</sup> Under the pre-revised Code's final payment rule, once final payment is made, "the payor bank shall be accountable for the *amount* of the item."<sup>74</sup> Thus, if a check is under-encoded, the payor bank remains liable for the amount of the check as written by the drawer. However, revised section 4-215 deletes this sentence, apparently in an attempt to prevent confusion.<sup>75</sup> Although it may

---

69. This hypothetical is taken directly from comment 2 to section 4-209 of the UCC.

70. See U.C.C. § 4-209, cmt. 2 (1990).

71. See *id.* § 4-215(a); see also Georgia R.R. Bank & Trust Co. v. First Nat'l Bank and Trust Co., 229 S.E.2d 482, 483-84 (Ga. Ct. App. 1976).

72. Section 4-213(1) of the pre-revised UCC read:

An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

- (a) paid the item in cash; or
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement; or
- (c) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement. *Upon a final payment under subparagraph (b), (c) or (d) the payor bank shall be accountable for the amount of the item.*

U.C.C. § 4-213(1) (pre-revised), reprinted in 5 WILLIAM D. HAWKLAND & LARY LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 4-213, at 522-23 (1994) (emphasis added).

73. Section 4-215(a) of the revised UCC reads:

An item is finally paid by a payor bank when the bank has first done any of the following:

- (1) paid the item in cash;
- (2) settled for the item without having a right to revoke the settlement under statute, clearing-house rule, or agreement; or
- (3) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing-house rule, or agreement.

U.C.C. § 4-215(a) (1990).

74. U.C.C. § 4-213(1)(d) (pre-revised), reprinted in 5 WILLIAM D. HAWKLAND & LARY LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 4-213, at 523 (1994) (emphasis added).

75. Comment 6 of revised section 4-215 provides as follows:

The last sentence of former Section 4-213(1) is deleted as an unnecessary source of confusion. Initially the view that payor bank may be accountable for, that is, liable for the amount of, an item that it has already paid seems incongruous. This

be true that in the vast majority of cases—where items are correctly encoded—it is not necessary to state that a bank which has “finally paid” the item is “accountable for its amount,” such a statement in the Code would be useful when an item has been misencoded. In the latter situation, this language would make it clear that regardless of the encoded amount, the payor bank remains liable for the full amount of the check as written by the drawer.

#### a. Recourse to the Drawer's Account

The underlying theme determining the obligations of the payor bank in the underencoding situation arises from the common law duty to mitigate damages.<sup>76</sup> As the beneficiary of the encoding warranty, the payor bank must first attempt to avoid any loss by recourse to the drawer's account.<sup>77</sup> Only then will the payor bank have a claim against the encoding bank for losses occurring as a result of the breach.

For example, *First National Bank v. Fidelity Bank*,<sup>78</sup> a case decided under pre-revised article 4, involved a check underencoded by \$90,000. First National, the depositary bank which made the encoding error, demanded payment of the \$90,000 difference from Fidelity Bank, the payor bank.<sup>79</sup> Fidelity, unable to honor First National's request because its customer's account did not have sufficient funds, refused to comply.<sup>80</sup> In determining the meaning of the “amount of the item” under pre-revised section 4-213, the court discussed the possibility of measuring the amount of the item by taking the lesser of the encoded amount or the face value of the check.<sup>81</sup> However, the court based its decision on equitable principles of estoppel,<sup>82</sup> which would act to prevent the depos-

---

is particularly true in the light of the language formerly found in Section 4-302 stating that the payor bank can defend against liability for accountability by showing that it has already settled for the item. But, at least with respect to the former Section 4-213(1)(c), such a provision was needed because under the process-of-posting test a payor bank may have paid an item without settling for it. Now that Article 4 has abandoned the process-of-posting test, the sentence is no longer needed. If the payor bank has neither paid the item nor returned it within its midnight deadline, the payor bank is accountable under Section 4-302.

U.C.C. § 4-215, cmt. 6 (1990).

76. See *First Nat'l Bank v. Fidelity Bank*, 724 F. Supp. 1168, 1172-73 (E.D. Pa. 1989) (stating that the right of the payor bank to hold the encoding bank liable for an encoding error is accompanied by the corollary obligation of the payor bank to mitigate damages by recourse to the drawer's account).

77. See U.C.C. § 4-209, cmt. 2 (1990); see also *infra* text accompanying notes 90-92.

78. 724 F. Supp. 1168 (E.D. Pa. 1989).

79. See *id.* at 1169.

80. See *id.*

81. See *id.* at 1172.

82. The court referenced section 1-103 of the UCC as support for its reliance on equitable principles. See *id.*

itary bank which made the encoding error from claiming more than the encoded amount. The court also emphasized that while the encoding bank was in the best position to prevent the loss and, therefore, should be held liable, the payor bank had the corollary obligation to mitigate damages by first obtaining recourse against the drawer's account.<sup>83</sup>

In *Georgia Railroad Bank & Trust Co. v. First National Bank and Trust Co.*,<sup>84</sup> another pre-revision Article 4 case, a similar situation occurred. Georgia Railroad Bank, the depository bank, underencoded a check by \$22,500.<sup>85</sup> When Georgia Railroad Bank demanded recovery of the \$22,500 from First National Bank, the payor bank, First National Bank refused because its customer, the drawer, had instructed the bank not to pay this check with funds from his account.<sup>86</sup> The court held that since the payor bank had finally paid the item, it was responsible for the full amount of the check as written by the drawer.<sup>87</sup> The court considered it important that the drawer at all times had sufficient funds in his account to pay the face amount of the check.<sup>88</sup> In fact, the court suggested that in the situation where the drawer has insufficient funds to cover the full amount of the check, the payor bank may have a defense or counterclaim against the encoding bank.<sup>89</sup> Although the court did not specifically refer to a common law duty of the payor bank to mitigate damages, given the outcome of this case, it is clear that this theme underlies the court's decision.

Under these pre-revision cases, it appears that once the payor bank makes a final payment of the underencoded item, it is responsible for at least the encoded amount of the check. Whether it is responsible to the depository bank for the full amount of the check may depend on whether there are sufficient funds in the drawer's account to cover the difference.

In our hypothetical, the payor bank, which debited the drawer's account for \$2500 instead of \$25,000, should look first to available funds in the drawer's account. This action is supported by comment 2 to section 4-209 of the UCC.<sup>90</sup> Comment 2 states that the payor bank suf-

---

83. See *id.*

84. 229 S.E.2d 482 (Ga. Ct. App. 1976).

85. See *id.* at 483.

86. See *id.*

87. See *id.* at 484.

88. The court specifically stated that the outcome may have been different if the payor bank had not been able to recover from the drawer due to insufficient funds in the drawer's account. See *id.*

89. See *id.* See also, *Bank One, Akron v. National City Bank*, 583 N.E.2d 429, 442 n.1 (Ohio Ct. App. 1990) (stating that the depository, encoding bank would be estopped from claiming more than the misencoded amount of the underencoded check, but that the payor bank would have a duty to mitigate damages by recourse to the account of the drawer of the check).

90. See U.C.C. § 4-209, cmt. 2 (1990); see also 1B JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 17-4 (3d ed. 1993) (suggesting that to recover damages for breach

fers a loss only to the extent that the drawer's account has insufficient funds to cover the full amount of the check and that the payor bank is not required to "pursue collection against the drawer *beyond* the amount in the drawer's account" to get the benefit of the warranty.<sup>91</sup> Therefore, it seems that section 4-209 requires payor bank to look first to funds available in the drawer's account before receiving any benefit from depositary bank's breach of the encoding warranty. As illustrated by the cases above, this requirement is also supported by pre-revised Article 4 case law.<sup>92</sup>

The underencoding scenario illustrates the relationship between the depositary bank and the payor bank. Under the final payment rule,<sup>93</sup> the payor bank is liable to the depositary bank for the full amount of the item. In the hypothetical which began this discussion,<sup>94</sup> we saw that in theory the payor bank is liable to the depositary bank for the \$22,500 difference. However, the payor bank now has a defense under section 4-209's encoding warranty. That defense allows payor bank to setoff its liability to the depositary bank under the final payment rule against the depositary bank's liability for breach of the encoding warranty. The extent of the setoff is the extent to which the drawer's account has insufficient funds to cover the additional amount due on the check at the time the payor bank learns of the underpayment.

#### b. Setoff Against Other Accounts of the Drawer

Once it is determined that the payor bank must first look to funds available in the drawer's account, the question then arises: what if there is not enough money in the drawer's account to cover the full amount of the check? May the payor bank properly take money from the drawer's other accounts with the payor bank? And is the payor bank required to

---

of the encoding warranty, the payor bank need only show that there are not enough funds available in the drawer's account to cover the item).

91. U.C.C. § 4-209, cmt. 2 (1990).

92. See *supra* text accompanying notes 77-90; see also *Azalea City Motels v. First Alabama Bank*, 551 So. 2d 967, 972 (Ala. 1989) (quoting at length from commentary stating that payor bank is authorized to debit drawer's account). This position is also supported by commentators. See, e.g., CLARK, *supra* note 33, ¶ 16.03[3] (stating that payor bank is "clearly authorized by the UCC to debit the [drawer's] account" under section 4-401).

One question not answered is what the result would be if the drawer's account never had sufficient funds to pay the check as underencoded or as drawn. In such a case, the payor bank's decision to pay the check would be a decision to extend credit to the drawer for the underencoded amount. Should the payor bank be accountable for the full amount of the check as drawn? Final payment rationale supports a holding that the payor bank is liable for the full amount in such a case. See *supra* notes 70-75 and accompanying text; cf. *Sonenberg v. Marine-Midland Bank*, 607 N.Y.S.2d 635, 635-36 (App. Div. 1994).

93. U.C.C. § 4-215 (1990).

94. See *supra* notes 69-75 and accompanying text.

do so before recovering damages under the encoding warranty? These issues involve the bank's right of setoff<sup>95</sup> and whether the bank must exercise its right of setoff to mitigate its damages. A bank may exercise its right to setoff if the following conditions are met: "(1) The funds must be the property of the debtor, deposited without restriction; (2) An existing debt must be due and owing; and (3) There must be mutuality of obligation between the debtor and creditor, as well as between debt and funds on deposit."<sup>96</sup>

The general rule of setoff applies to any account of the debtor which is general in nature, that is, deposited without restriction.<sup>97</sup> Thus, as long as the other account of drawer is the drawer's own account, and not some third party's account, and the account was not set up for some special purpose, such as a trust account, then funds on deposit in that other account should be reachable for setoff purposes. This would satisfy the first requirement a bank must meet in order to exercise its right of setoff.

The requirement of mutuality is satisfied if the debt against which setoff is exercised is between the same parties, standing in the same capacity.<sup>98</sup> Generally, the nature of the relationship between a bank and its depositor is that of debtor and creditor.<sup>99</sup> The depositor is a creditor of the bank (the debtor) to the extent the depositor has funds on deposit with the bank. In the underencoding situation, the condition of mutuality is satisfied if the depositor/drawer owns the other account against which setoff is being exercised in the same capacity as he or she owns the account against which the underencoded check was drawn.<sup>100</sup>

Assume in our underencoding hypothetical,<sup>101</sup> that the \$25,000 check was written on account number one, which originally had a balance of \$35,000. However, by the time the demand was made for payment of the remaining \$22,500 out of account number one, the balance had fallen to \$10,000. Further assume that the same drawer has another account with the payor bank (account number two) which has a \$5000

---

95. For a general discussion of bank setoff, see CLARK, *supra* note 33, ch. 18.

96. CLARK, *supra* note 33, ¶ 18.06.

97. *See id.*; see also *Carpenters So. Cal. Admin. Corp. v. Manufacturers Nat'l Bank*, 910 F.2d 1339, 1341 (6th Cir. 1990); *In re Nat Warren Contracting Co.*, 905 F.2d 716, 718 (4th Cir. 1990); *In re Texas Mortgage Serv. Corp.*, 761 F.2d 1068, 1075 n.11 (5th Cir. 1985); *Bank One, Akron v. National City Bank*, 583 N.E.2d 439, 442 (Ohio Ct. App. 1990).

98. *See* CLARK, *supra* note 33, ¶ 18.06.

99. *See id.*; see also *American Bank v. Waco Airmotive, Inc.*, 818 S.W.2d 163, 170 (Tex. Ct. App. 1991).

100. If the drawer owned the first account, against which the underencoded check was drawn, in his or her individual capacity as opposed to as trustee, for example, then the second account, against which setoff is to be exercised, must also be owned in the depositor's individual capacity. *See* CLARK, *supra* note 33, ¶ 18.06.

101. *See supra* note 69 and accompanying text.



balance. It is consistent with the law governing setoff for payor bank to recover that \$5000 by setoff from account number two. Must it do so in order to assert its rights against the depository bank as a beneficiary of the encoding warranty? If the payor bank pays the check drawn on account number one despite the creation of an overdraft, does the payor bank have the right of setoff against account number two and the obligation to use setoff against account number two before recovering any remaining shortfall from the depository bank under the encoding warranty?

A good starting point in determining whether the payor bank can reach funds in the drawer's other accounts is section 4-401 of the UCC. This section states that "[a] bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft."<sup>102</sup> The section further states that an item is properly payable if the customer authorized it and if it is in compliance with any agreement between the parties.<sup>103</sup>

Section 4-401's authorization for a bank to pay an item even though it creates an overdraft does not leave the bank without a remedy, however. When an overdraft results, a debt is created which entitles the bank to enforce the debt in the same manner as it would a loan or a promissory note.<sup>104</sup> This situation is analogous to the payor bank's position when a check written by the drawer is underencoded by the encoding bank. Even though the check was underencoded, the drawer is still obligated to reimburse the payor bank for the full amount of the check as written.<sup>105</sup> A strong argument exists, therefore, that the second requirement of setoff, an existing debt that is due and owing, is met when the payor bank pays the underencoded amount, because the drawer is still liable for the amount of the check as written.

Case law interpreting section 4-401 proves helpful in determining whether a payor bank can have recourse against other accounts of the drawer. *Pacenta v. American Savings Bank*<sup>106</sup> addresses this issue. Plaintiff had a joint checking account with her husband at American

---

102. U.C.C. § 4-401(a) (1990).

103. *See id.*

104. *See United States v. Christo*, 614 F.2d 486, 493 (5th Cir. 1980); *see also Pacenta v. American Sav. Bank*, 552 N.E.2d 1276, 1278 (Ill. App. Ct. 1990) (stating that the law under the UCC is well settled that an overdraft situation creates a loan by the bank to the drawer for which the drawer is liable); *United States Trust Co. v. McSweeney*, 457 N.Y.S.2d 276, 278 (App. Div. 1982) (citing the common law rule that the payment of an overdraft by a bank creates a loan for which the drawer is liable); *Tony's Tortilla Factory v. First Bank*, 857 S.W.2d 580, 584 (Tex. Ct. App. 1993), *aff'd in part and rev'd in part*, 877 S.W.2d 285 (Tex. 1994) (explaining that when a bank pays a check which creates an overdraft, it has made a loan to its customer).

105. *See U.C.C. § 4-401(a)* (1990).

106. 552 N.E.2d 1276 (Ill. App. Ct. 1990).

Savings Bank.<sup>107</sup> When an overdraft occurred in the joint checking account, American Savings cashed in a certificate of deposit held by the plaintiff *individually* to cover the amount of the overdraft.<sup>108</sup> The court upheld the bank's action, holding that "a bank has the right, under the Code, to unilaterally charge this debt against *any* account the plaintiff customer may have with the bank, including plaintiff's individual account or CD."<sup>109</sup> The court referred to the very broad language found in the Code, especially the definitions of such words as "account"<sup>110</sup> and "customer,"<sup>111</sup> to support its conclusion.

Although *Pacenta* involved an overdraft situation, it is nevertheless strong support for the proposition that the payor bank should be able to exercise its right of setoff against other accounts of the drawer. There is very little case law regarding setoff of other accounts of the drawer in the underencoding scenario. *First National Bank v. Fidelity Bank*,<sup>112</sup> comes close to addressing this issue, albeit only in dicta. In this case, when the underencoding error occurred, the drawer had insufficient funds in the account upon which the check was drawn<sup>113</sup> and refused to permit Fidelity, the payor bank, to use funds from any of its other accounts to cover the error.<sup>114</sup> Later, after Fidelity and the drawer reached an agreement, Fidelity closed the drawer's remaining accounts and returned their contents, totaling \$101,383.61, to the drawer.<sup>115</sup> The depository bank sued Fidelity, asserting Fidelity was liable for the \$90,000 encoding error.<sup>116</sup> In holding that Fidelity was not liable to the depository bank, the court stated: "Fidelity had no legal right to freeze [the drawer's] other accounts, and certainly had no obligation to do so."<sup>117</sup> This last statement by the court in *First National Bank* may be

---

107. *See id.* at 1277.

108. *See id.*

109. *Id.* at 1280 (emphasis added).

110. Revised Article 4 defines "account" as "any deposit or credit account with a bank, including a demand, time, savings, passbook, share draft, or like account, other than an account evidenced by a certificate of deposit." U.C.C. § 4-104(a)(1) (1990). *Pacenta* was decided under pre-revised Article 4's definition of "account," which did not exclude certificates of deposit. *See* U.C.C. § 4-104(1)(a) (pre-revised), reprinted in 5 WILLIAM D. HAWKLAND & LARY LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 4-104, at 220 (1994).

111. "Customer" is defined as "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank." U.C.C. § 4-104(a)(5) (1990). This definition is the same in pre-revised article 4. *See* U.C.C. § 4-104(1)(e) (pre-revised), reprinted in 5 WILLIAM D. HAWKLAND & LARY LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 4-104, at 220 (1994).

112. 724 F. Supp. 1168 (E.D. Pa. 1989).

113. *See id.* at 1169.

114. *See id.* at 1170.

115. *See id.*

116. *See id.*

117. *Id.* at 1173.

inaccurate; the holding and rationale in *Pacenta* seem more in line with the law of setoff.

If the payor bank is able to exercise its right of setoff against the drawer's other accounts, the next question is whether it is *required* to do so before seeking recovery from the encoding bank. This is essentially a mitigation of damages question.<sup>118</sup> The doctrine of mitigation of damages "imposes on [a] party injured by breach of contract or tort [a] duty to exercise reasonable diligence and ordinary care in attempting to minimize his damages."<sup>119</sup> Numerous courts have applied this doctrine in cases involving article 4 issues. For example, in *Pulaski Bank and Trust v. Texas American Bank/Fort Worth*,<sup>120</sup> a Texas court applied the doctrine to diminish damages recoverable by a depository bank which failed to freeze the account of a customer after it received notice from the payor bank that the payor bank had dishonored an item deposited by the customer. Although the notice of dishonor was not timely, the court held that had the depository bank put a hold on its customer's account when it received the tardy notice, it could have avoided approximately \$46,000 in damages.<sup>121</sup> Consequently, the court reduced the depository bank's recovery by this amount.<sup>122</sup>

Therefore, while section 4-209 of the UCC does not expressly require the payor bank to exercise its right of setoff against the drawer's other accounts, the common law duty to mitigate damages requires the payor bank to use the funds available for setoff in the drawer's other accounts before claiming the benefit of the encoding warranty and thus avoiding paying the presenting bank the full and correct amount of the underencoded check. This forces the drawer to cover the check as origi-

---

118. See *TCP Indus. v. Uniroyal, Inc.*, 661 F.2d 542, 550 (6th Cir. 1981), where the court states:

While we agree that the U.C.C. contains no specific provision requiring mitigation under the factual circumstances existing here [sale of goods under U.C.C. Art. 2], we find Uniroyal's application of Section 440.1103 [U.C.C. § 1-103] appropriate in this case.

Generally speaking, all facts or circumstances which go to a reduction in the amount necessary to compensate plaintiff on account of the wrong for which the suit is brought may be shown in mitigation of damages . . . . The buyer could not be charged with damages which, with reasonable effort, the seller could have prevented; and the seller should exercise ordinary care and diligence to prevent further loss to the buyer, after notice from him that he will not perform the contract. . . .

The Uniform Commercial Code should not affect any of the above principles, since supplementary general principles of law and equity are retained. (quoting 67 Am.Jur.2d *Sales* § 653 (1973)).

119. BLACK'S LAW DICTIONARY 1002 (6th ed. 1990).

120. 759 S.W.2d 723 (Tex. Ct. App. 1988).

121. See *id.* at 735-36.

122. See *id.* at 736.

nally drawn through quick and efficient access to his or her funds on deposit with the payor bank.<sup>123</sup> If this duty to mitigate damages applies, it should not matter if the original decision to pay from account number one created an overdraft.

#### E. *Is Subrogation Available as a Defense to Either the Payor Bank or the Depositary Bank?*

Section 4-407 of revised article 4 gives the payor bank subrogation rights when it improperly pays an item.<sup>124</sup> Although this section is applied most frequently in situations where the payor bank has paid an item over a valid stop payment order from its customer,<sup>125</sup> it is also applicable where the payor bank has paid an item "under circumstances giving a basis for objection by the drawer or maker, to prevent unjust

123. If the payor bank either could not or had no duty to exercise setoff against the drawer's other accounts, the drawer would ultimately be liable to the depositary bank. The depositary bank could recover from the drawer under the principle of restitution to prevent unjust enrichment. Cf. *infra* notes 138-42 and accompanying text.

The depositary bank would be liable to its customer depositor for the correct amount of the check because of its failure to use ordinary care in encoding the item. See U.C.C. § 4-202(a)(1) (1990). But damages in such a case are limited to "the amount of the item reduced by an amount that could not have been realized by the exercise of ordinary care." U.C.C. § 4-103(e). Therefore, even if the check has been properly encoded, in cases where the drawer never had sufficient funds to pay, the risk is on the customer depositor. But the risk is on the depositary bank in cases where the drawer refuses to pay without excuse and had funds on deposit sufficient to pay had the check been correctly encoded.

124. See U.C.C. § 4-407 (1990). Section 4-407 provides:

If a payor bank has paid an item over the order of the drawer or maker to stop payment, or after an account has been closed, or otherwise under circumstances giving a basis for objection by the drawer or maker, to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the item, the payor bank is subrogated to the rights

- (1) of any holder in due course on the item against the drawer or maker;
- (2) of the payee or any other holder of the item against the drawer or maker either on the item or under the transaction out of which the item arose; and
- (3) of the drawer or maker against the payee or any other holder of the item with respect to the transaction out of which the item arose.

*Id.*

Note that cases discussed in this section interpret pre-revised section 4-407. This earlier version of the section, however, is basically just re-worded in revised article 4. The only real change is that the new section specifically adds payment after an account has been closed to the list of circumstances that trigger subrogation rights. See Henry J. Bailey, *New 1990 Uniform Commercial Code: Article 3, Negotiable Instruments, and Article 4, Bank Deposits and Collections*, 29 WILLAMETTE L. REV. 409, 564-65 (1993).

125. See 6B HAWKLAND & LAWRENCE, *supra* note 28, [Rev] § 4-407:01; see, e.g., Deppoliti's N.E. Auction Ctr. v. Birmingham Sav. Bank, 584 N.Y.S.2d 922, 923-24 (1992) (affirming payor bank's right to subrogation of drawer's rights against payee when bank paid item over drawer's valid stop payment order).

enrichment."<sup>126</sup>

To see just how valuable subrogation rights can be, consider the following example. Suppose the drawer issues a check for \$2000 to payee as partial payment for a debt that is currently due and payable in the amount of \$30,000. The depositary bank overencodes this check for \$20,000, and the payor bank pays that amount to the depositary bank. The depositary bank then credits it to the payee's account. Clearly in this situation the drawer has a basis for objection because the payor bank paid \$18,000 more than the amount written by the drawer. However, if the debt is currently due and payable in the amount of \$30,000, the payee may be entitled to retain the \$18,000.<sup>127</sup> If the payor bank is subrogated to the rights of the payee against the drawer, the drawer (customer) would not be able to recover against the payor bank (the customer's bank) in any case where the payee would be entitled to retain the \$18,000 mistakenly paid as a result of the overencoding.

Does a payor bank which improperly pays an item due to an encoding error have the benefit of subrogation? To answer this question, it must be determined whether an encoding error falls under "circumstances giving a basis for objection by the drawer or maker."<sup>128</sup> In cases of overencoding, it seems obvious that the drawer has a "basis for objection" when the payor bank pays the overencoded amount. The drawer should also find it objectionable in underencoding cases, when the payor bank fails to pay the full amount the drawer ordered. This failure can disrupt a contractual relationship between the drawer and payee, who is entitled to the full amount of the check.

Several courts have held that section 4-407 is "all-embracing" and not limited to payments over valid stop payment orders.<sup>129</sup> For example, in *American Communications Telecommunications, Inc. v. Commerce North Bank*,<sup>130</sup> the court held that the payor bank improperly paid an item when it honored a check that featured signatures that were not in compliance with the agreement between the bank and its customer.<sup>131</sup> However, the payor bank was subrogated to the rights of the payee, who

---

126. U.C.C. § 4-407 (1990).

127. See, e.g., *Banque Worms v. Bankamerica Int'l*, 570 N.E.2d 189, 192 (N.Y. 1991) (discussing two different rules in American law under which a payment received by mistake may be retained by the recipient: the "mistake of fact" doctrine and the "discharge for value" rule).

128. U.C.C. § 4-407 (1990). See also *supra* note 124 for text of section 4-407.

129. *Peck v. Franklin Nat'l Bank*, 4 U.C.C. Rep. Serv. 861, 861 (N.Y. App. Term 1967); see also *Desiree Mines, Ltd. v. Provident Nat'l Bank*, 25 U.C.C. Rep. Serv. 1129, 1131 (Pa. Ct. C.P. 1978) (stating that although most reported cases under section 4-407 involve payment over stop payment orders, the provision is not restricted to such events, but extends to any circumstance giving rise to objection by the drawer or maker).

130. 691 S.W.2d 44 (Tex. Ct. App. 1985).

131. See *id.* at 46.

was entitled to be paid under a contract with the drawer.<sup>132</sup> The drawer was therefore denied any recovery against the payor bank.<sup>133</sup> In *Peck v. Franklin National Bank*,<sup>134</sup> the payor bank paid a post-dated check prior to the date on the check.<sup>135</sup> Here again, the court allowed the payor bank to be subrogated to the payee's rights in the underlying transaction.<sup>136</sup> Thus, the broad language of section 4-407, together with case law interpreting pre-revised section 4-407, support the view that a payor bank may have subrogation rights when it improperly pays an item due to an encoding error.<sup>137</sup>

Subrogation rights under section 4-407 are only available to the payor bank.<sup>138</sup> Therefore one is left to wonder from what source might the depositary bank claim the benefit of subrogation. Perhaps the best answer lies in the language of section 4-407 itself.<sup>139</sup> Section 4-407 declares as its purpose the prevention of unjust enrichment.<sup>140</sup> In the overencoding situation discussed above,<sup>141</sup> permitting the drawer to recover from the payor bank while receiving the benefit of the discharge of a debt that was currently due would result in unjust enrichment. In such a case the depositary bank should certainly be subrogated to the rights of the payee against the drawer under section 1-103 of the UCC,<sup>142</sup> if not under section 4-407.

---

132. *See id.*

133. *See id.* at 47.

134. 4 U.C.C. Rep. Serv. 861 (N.Y. App. Term 1967).

135. *See id.* at 862.

136. *See id.*

137. If a court holds that payor bank has no right to recover from the payee under section 4-407 of the UCC, there is case authority holding that the common law right to restitution still exists. *See Bryan v. Citizens Nat'l Bank*, 628 S.W.2d 761, 764 (Tex. 1982). *See also* U.C.C. § 4-403, cmt. 7 (1990), which states:

The drawee is, however, entitled to subrogation to prevent unjust enrichment (Section 4-407); retains common law defenses, e.g., that by conduct in recognizing the payment the customer [payee] has ratified the bank's action in paying over a stop payment order (Section 1-103); and retains common law rights, e.g., to recover money paid under a mistake under Section 3-418.

*Id.*

138. *See* U.C.C. § 4-407 (1990); *see also* *American Nat'l Bank & Trust v. St. Joseph Valley Bank*, 389 N.E.2d 379, 382-83 (Ind. Ct. App. 1979).

139. *See supra* note 124.

140. *See* U.C.C. § 4-407 (1990).

141. *See supra* note 127 and accompanying text.

142. Section 1-103 of the UCC states:

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions. U.C.C. § 1-103 (1990); *see also supra* note 137 (noting that common law right to restitution still exists).

### III. REGULATION CC § 229.34 ENCODING WARRANTY

The Federal Reserve Board enacted its own encoding warranty, effective January 3, 1994.<sup>143</sup> Although to some extent the Regulation CC encoding warranty overlaps the UCC encoding warranty, there are significant differences.

#### A. *Who Makes the Warranty?*

The warranting parties under Regulation CC include "each bank that presents or transfers a check or returned check."<sup>144</sup> The warranty is not limited to the person who does the actual encoding as in section 4-209 of the UCC. In addition, every intermediary collecting bank in the forward collection chain, as well as every bank in the return process, makes the warranty. Therefore, the encoding warranty found under Regulation CC is more expansive than the UCC's encoding warranty.<sup>145</sup>

#### B. *To Whom Is the Warranty Made?*

Regulation CC's encoding warranty is made to any bank that subsequently handles the check.<sup>146</sup> This includes the payor bank and any other bank handling the item subsequent to the encoding. The encoding warranty under section 4-209 of the UCC is made to those same parties.<sup>147</sup>

---

143. The warranty is codified at 12 C.F.R. § 229.34(c), which reads:

(c) *Warranty of settlement amount, encoding, and offset.* (1) Each bank that presents one or more checks to a paying bank and in return receives a settlement or other consideration warrants to the paying bank that the total amount of the checks presented is equal to the total amount of the settlement demanded by the presenting bank from the paying bank.

(2) Each bank that transfers one or more checks or returned checks to a collecting, returning, or depository bank and in return receives a settlement or other consideration warrants to the transferee bank that the accompanying information, if any, accurately indicates the total amount of the checks or returned checks transferred.

(3) Each bank that presents or transfers a check or returned check warrants to any bank that subsequently handles it that, at the time of presentment or transfer, the information encoded after issue in magnetic ink on the check or returned check is correct.

(4) A paying bank may set off the amount by which the settlement paid to a presenting bank exceeds the total amount of the checks presented against subsequent settlements for checks presented by that presenting bank.

12 C.F.R. § 229.34(c) (1996).

144. 12 C.F.R. § 229.34(c)(3).

145. See 12 C.F.R. pt. 229, app. E, at 523.

146. See 12 C.F.R. § 229.34(c)(3).

147. See *supra* Part II.B.

### C. What Does the Warranty Cover?

The Regulation CC encoding warranty warrants that "the information encoded after issue in magnetic ink on the check or returned check is correct."<sup>148</sup> In essence, this warranty covers the same information as does the UCC's encoding warranty.<sup>149</sup> However, Regulation CC's encoding warranty applies to return items, in addition to the forward collection process,<sup>150</sup> and further warrants that the settlement demanded from intermediary and payor banks matches the total of the items sent with the demand for settlement.<sup>151</sup> These differences result from the desire of the Federal Reserve Board to increase the efficiency of the return process.<sup>152</sup>

### D. What Damages Are Recoverable?

Damages for breach of Regulation CC's encoding warranty are limited to "the consideration received by the bank . . . plus interest compensation and expenses related to the check or returned check, if any."<sup>153</sup> The Official Commentary to Regulation CC specifically adopts the damages provisions provided in sections 4-207(c) and 4A-506(b) of the UCC.<sup>154</sup> Section 4-207(c) addresses the damages recoverable for breach of the transfer warranty,<sup>155</sup> and section 4A-506(b) uses the federal funds rate to determine the rate of interest to use when calculating interest as

---

148. 12 C.F.R. § 229.34(c)(3).

149. See *supra* Part II.C.

150. See *infra* Part III.E.

151. See 12 C.F.R. § 229.34(c)(1)-(2). This additional warranty of the accuracy of the settlement demand is part of the mechanism for an efficient and rapid recovery of damages by the injured bank. See *infra* Part III.E.

152. See William H. Lawrence, *Changes in Check Collection and Access to Funds: Regulation CC and Revised UCC Article 4*, 61 J. KAN. B. ASS'N 26, 28 (1992).

153. 12 C.F.R. § 229.34(d). The subsection, in its entirety, reads: "Damages. Damages for breach of these warranties shall not exceed the consideration received by the bank that presents or transfers a check or returned check, plus interest compensation and expenses related to the check or returned check, if any." 12 C.F.R. § 229.34(d).

The mechanism for damage recovery under Regulation CC's encoding warranty is found under 12 C.F.R. § 229.34(c)(4). This section states as follows: "A paying bank may set off the amount by which the settlement paid to a presenting bank exceeds the total amount of the checks presented against subsequent settlements for checks presented by that presenting bank." 12 C.F.R. § 229.34(c)(4); see also 57 Fed. Reg. 46,966 (Oct. 14, 1992).

When a presenting bank presents items to the payor bank, it is usually in the form of a cash letter. This cash letter lists all of the items for presentment and combines all of the items into one total. When the payor bank makes settlement payments to the presenting bank, it is for this total amount. DOLAN, *supra* note 4, at § 23.3. If an item with an overencoding error is included in this total, 12 C.F.R. § 229.34(c)(4) allows the payor bank to make appropriate adjustments to future settlement payments to that same presenting bank.

154. See 12 C.F.R. pt. 229, app. E, at 524.

155. Section 4-207 of the UCC provides:

(a) A customer or collecting bank that transfers an item and receives a



damages.<sup>156</sup>

Under section 4-207(c), damages for breach of the transfer warranty are limited to "an amount equal to the loss suffered as a result of the breach, but not more than the amount of the item plus expenses and loss of interest incurred as a result of the breach."<sup>157</sup> The loss suffered as a result of a breach of the transfer warranty is the difference between the value of the item as warranted and the value based on the circumstances that caused the warranty to be breached.<sup>158</sup> This recovery is limited to the amount of the item;<sup>159</sup> therefore, consequential damages are

settlement or other consideration warrants to the transferee and to any subsequent collecting bank that:

- (1) the warrantor is a person entitled to enforce the item;
- (2) all signatures on the item are authentic and authorized;
- (3) the item has not been altered;
- (4) the item is not subject to a defense or claim in recoupment (Section 3-305(a)) of any party that can be asserted against the warrantor; and
- (5) the warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.

(b) If an item is dishonored, a customer or collecting bank transferring the item and receiving settlement or other consideration is obliged to pay the amount due on the item (i) according to the terms of the item at the time it was transferred, or (ii) if the transfer was of an incomplete item, according to its terms when completed as stated in Sections 3-115 and 3-407. The obligation of a transferor is owed to the transferee and to any subsequent collecting bank that takes the item in good faith. A transferor cannot disclaim its obligation under this subsection by an indorsement stating that it is made "without recourse" or otherwise disclaiming liability.

(c) A person to whom the warranties under subsection (a) are made and who took the item in good faith may recover from the warrantor as damages for breach of warranty an amount equal to the loss suffered as a result of the breach, but not more than the amount of the item plus expenses and loss of interest incurred as a result of the breach.

(d) The warranties stated in subsection (a) cannot be disclaimed with respect to checks. Unless notice of a claim for breach of warranty is given to the warrantor within 30 days after the claimant has reason to know of the breach and the identity of the warrantor, the warrantor is discharged to the extent of any loss caused by the delay in giving notice of the claim.

(e) A cause of action for breach of warranty under this section accrues when the claimant has reason to know of the breach.

U.C.C. § 4-207 (1990).

156. *See id.* § 4A-506(b) (1990).

157. *Id.* § 4-207(c).

158. *See* 6B HAWKLAND & LAWRENCE, *supra* note 28, [Rev] § 4-207:01. *See also supra* note 155 for the text of the transfer warranty.

159. *See* First City Nat'l Bank v. FDIC, 782 F.2d 1344, 1350 (5th Cir. 1986) (allowing payor bank, which had reimbursed its customer, to be subrogated to the customer's rights to recover the amount of the check from the depository bank); First Guar. Bank v. Northwest Ga. Bank, 417 S.E.2d 348, 352 (Ga. Ct. App. 1992) (defining "'consideration received'" as "'the proceeds of collection'" based on comments 2 and 5 to pre-revised section 4-207). *But see* County of Pierce v. Suburban Bank, 815 F. Supp. 1124, 1126-27 (N.D. Ill. 1993) (holding that injured party has no

not recoverable under section 4-207's warranty, although they appear to be under section 4-209's encoding warranty.<sup>160</sup> As with the encoding warranty under section 4-209, a person claiming damages for breach of the transfer warranty must have taken the item in good faith.<sup>161</sup>

Case law concerning damages recoverable under the pre-revised article 4 transfer and presentment warranties<sup>162</sup> has centered around determining what expenses are recoverable. For example, in *First Virginia Bank-Colonial v. Provident State Bank*,<sup>163</sup> a payor bank sought recovery—including attorneys fees—from a depository bank which had breached its presentment warranty by paying an item with a forged endorsement.<sup>164</sup> The court concluded that recovery of attorneys fees should be allowed in this instance.<sup>165</sup> In contrast, other courts have denied recovery of attorneys fees in breach of warranty cases.<sup>166</sup>

The main difference between the encoding warranties found under Regulation CC and the UCC lies in the damages provision of each statute. As discussed above, under section 4-209 of the UCC, recovery includes not only the amount of the item, but any loss suffered as a result of the breach.<sup>167</sup> In the overencoding cases, this apparently includes consequential damages, such as loss recoverable for wrongful dis-

---

right to automatic damages for breach of transfer warranty claim, and must show actual damages resulting from breach in order to recover); *Geldert v. American Nat'l Bank*, 506 N.W.2d 22, 28 (Minn. Ct. App. 1993) (limiting the amount recoverable to amount payor bank received in settlement of payee's claims when payee acquired payor bank's breach of warranty claims against the depository and collecting banks).

Note that under section 4-207's transfer warranty, the injured party must give notice of the breach to the warrantor within thirty days after the claimant had reason to know of the breach. See U.C.C. § 4-207(d) (1990). If there is a delay in giving notice, the amount of loss caused by the delay is not recoverable from the warrantor. *Id.* It is interesting to observe that Regulation CC's drafters did not adopt this notice provision.

160. See *supra* Part II.D.2.

161. See *supra* Parts II.D.1-2. Although not specifically stated in Regulation CC, presumably this same requirement applies under Regulation CC's damages provision.

162. U.C.C. § 4-207(3) (pre-revised), reprinted in 5 WILLIAM D. HAWKLAND & LARY LAWRENCE, UNIFORM COMMERCIAL CODE SERIES § 4-207, at 432 (1994). In the pre-revised code, the damages provisions for breach of the transfer and presentment warranties are the same.

163. 582 F. Supp. 850 (D. Md. 1984).

164. See *id.* at 851.

165. See *id.* at 852; see also *Southern Provisions, Inc. v. Harris Trust & Sav. Bank*, 422 N.E.2d 33, 35 (Ill. App. Ct. 1981) (holding that the decision whether to award attorneys fees and litigation costs is within trial court's discretion). Comment 7 to section 4-207 of the revised Code refers to section 3-416, article 3's version of the transfer warranty. See U.C.C. § 4-207, cmt. 7 (1990). Comment 6 to section 3-416 states that although there is no express provision allowing recovery of attorneys fees as expenses, recovery of attorneys fees is permissible. See *id.* § 3-416 cmt. 6. Other state law should decide when these fees are recoverable. See *id.*

166. See *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 774-76 (3rd Cir. 1990); *First Nat'l Bank v. Plymouth-Home Nat'l Bank*, 553 F. Supp. 448 (D. Mass. 1982), *aff'd*, 705 F.2d 439 (1st Cir. 1983).

167. See U.C.C. § 4-209(c) (1990).

honor.<sup>168</sup> Recovery under Regulation CC is not so generous, in that it limits damages to the amount of the item, plus expenses and interest.<sup>169</sup> Given the difference in the potential recovery under the two encoding warranties, if the UCC's encoding warranty is not preempted by Regulation CC,<sup>170</sup> an injured party would need to decide how to proceed, especially where that party is a payor bank that wrongfully dishonored the drawer's properly payable items because of an overencoded check.<sup>171</sup> This decision will turn in part on how damages are recovered under the two warranty provisions.

E. *How Are Damages Recovered in Cases of Overencoding?*

Under Regulation CC, the payor bank can recover part of the damages from overencoding a check easily and quickly through setoff against subsequent settlements for checks presented by the presenting bank that overencoded.<sup>172</sup> No litigation is necessary to exercise this right of setoff, because the amount involved (the amount by which the item was overencoded) is easy to calculate and subject to no dispute. Permitting the injured bank to recover that amount by setoff provides the injured bank with an immediate self-help remedy.<sup>173</sup> This setoff provision, however, does not include recovery of interest and other incidental expenses.<sup>174</sup> Therefore, an injured bank that seeks to recover more than the overencoded amount must undertake litigation.

In contrast, all damages under section 4-209 of the UCC must be recovered by litigation. The UCC makes no provision for the payor bank to recover by setoff against subsequent settlements for checks presented by the misencoding depository bank. Furthermore, arriving at a consequential damages figure under section 4-209 in the overencoding situation may involve many complex issues, making it more suitable for litigation.<sup>175</sup> A bank injured by breach of the encoding warranty might find it better to use the Regulation CC's setoff damage recovery provision rather than litigate, unless it has suffered significant lost interest, incidental expenses, or consequential damages that can only be recov-

---

168. See *supra* Part II.D.2.

169. See 12 C.F.R. § 229.34(d).

170. See *infra* Part IV (discussing whether Regulation CC's encoding warranty preempts any or all of section 4-209).

171. See *infra* Part IV.C.

172. See 12 C.F.R. § 229.34(c)(4); see also *supra* note 153.

173. See EDWARD L. RUBIN & ROBERT COOTER, *THE PAYMENT SYSTEM* 452 (2d ed. 1994). As will be seen below, the author of this Article disagrees with the conclusion of Professors Rubin and Cooter that Regulation CC preempts section 4-209, at least to the extent that they believe the preemption is total.

174. See 12 C.F.R. § 229.34(d).

175. See, e.g., *supra* Part II.D.3, II.E.

ered through litigation. Of course, this analysis assumes that Regulation CC did not preempt the possibility of recovering consequential damages—a topic discussed below in Part IV.

#### F. *Procedure in Cases of Underencoding*

What defenses are available under Regulation CC to the depositary bank which underencodes? From comment 2 to section 4-209, one may infer that the payor bank must attempt to recover from the drawer's account the difference between the correct amount of the check (for which the payor bank is liable to the depositary bank) and the under-encoded amount in order to recover from the misencoding depositary bank for breach of warranty.<sup>176</sup> Under Regulation CC, must the payor bank make such an attempt to recover first from its customer's account before seeking recovery from the depositary bank for breach of warranty? Regulation CC states that "[a] paying bank may set off the amount by which the settlement paid to a presenting bank *exceeds* the total amount of the checks presented against subsequent settlements for checks presented by that presenting bank."<sup>177</sup> The setoff procedure discussed above for overencoding cases thus does not apply in cases of underencoding, because the settlement paid to the presenting depositary bank will be less than, instead of exceeding, the true total amount of the checks presented. Therefore, the analysis of mitigation issues in Part II.D.3 should apply to underencoding cases under Regulation CC. Probably because these issues exist in most underencoding cases, Regulation CC does not provide any self-help, setoff method for recovery by either depositary or payor bank against future settlements between them in these cases. Recovery of damages in these cases must be through litigation.

#### G. *Application to Return Items*

One area in which there may be no overlap between section 4-209 and Regulation CC § 229.34(c) is the return process. Regulation CC applies to "[e]ach bank that presents or transfers a check *or returned check*."<sup>178</sup> Thus, the encoding warranty under Regulation CC applies to both the forward collection process and returned checks.<sup>179</sup> This application to return items is in harmony with Regulation CC's concern with

---

176. See *supra* Part II.D.3.a.

177. 12 C.F.R. § 229.34(c)(4) (emphasis added).

178. 12 C.F.R. § 229.34(c)(3) (emphasis added).

179. See *id.*; 12 C.F.R. pt. 229, app. E, at 523; see also Robert D. Mulford, *New Federal Reserve Actions Modifying the UCC: Intraday Posting, Same-Day Settlement, and MICR Encoding Warranties*, 26 UCC L.J. 99, 109-10 (1993). Regulation CC clearly distinguishes between forward collecting banks and returning banks. See 12 C.F.R. § 229.2(cc).

making the return process as expeditious as the forward collection process.<sup>180</sup>

Although most commentators agree that the majority of Article 4 applies only to the forward collection process and not the return process,<sup>181</sup> an argument can be made that the UCC's encoding warranty under section 4-209 applies to the return process as well. The language of section 4-209 does not expressly preclude application to the return process. The provision reads: "A person who encodes information on or with respect to an item after issue warrants to any subsequent collecting bank and to the payor bank or other payor that the information is correctly encoded."<sup>182</sup> "Collecting bank" is defined as a bank which handles an item for collection.<sup>183</sup>

This argument is perhaps strongest in regard to the qualified return process. A qualified returned check is a "returned check that is prepared for automated return to the depository bank by placing the check in a carrier envelope or placing a strip on the check and encoding the strip or envelope in magnetic ink."<sup>184</sup> Suppose a payor bank dishonors an item and sends a qualified returned check back to the depository bank. The payor bank overencodes the amount field, causing the depository bank to take more money out of its customer's account than it had originally credited. In this situation, arguably the depository bank, which is a collecting bank,<sup>185</sup> should have the benefit of the UCC's encoding warranty, and the payor bank, which overencoded the check, should be held to have made the warranty. This would be in keeping with section 4-209's policy of placing the loss on the party that misencodes the information, as it was the party in the best position to prevent the loss.

#### IV. HOW MUCH OF U.C.C. § 4-209 IS PREEMPTED?

##### A. *Preemption in General*

Preemption analysis begins with Article VI of the U.S. Constitution—better known as the "Supremacy Clause"—which provides: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; . . . shall be the supreme law of the land; . . . any Thing in the Constitution or Laws of any State to the Contrary notwith-

---

180. See Lawrence, *supra* note 152, at 28; see also CLARK, *supra* note 33, ¶ 8.14[2] (stating that "the overarching purpose behind Subpart C [of Part 229 of Regulation CC] is to establish rules requiring quicker return of dishonored checks").

181. See CLARK, *supra* note 33, ¶ 8.14[2][a] (stating that "the entire thrust of Part 2 of Article 4 is the *forward collection process*").

182. U.C.C. § 4-209(a) (1990).

183. *Id.* § 4-105(5).

184. 12 C.F.R. § 229.2(bb).

185. See U.C.C. § 4-105(5) (1990).

standing.”<sup>186</sup> Thus, it is well settled that any state law that conflicts with federal law is “without effect.”<sup>187</sup> The starting point for determining whether a federal law preempts a state statute is congressional intent.<sup>188</sup> That intent may be evidenced in two ways: it may be “explicitly stated in the statute’s language or implicitly contained in its structure and purpose.”<sup>189</sup> Congress may expressly state in a piece of legislation that it has preempted the entire field,<sup>190</sup> or that intent may be inferred.<sup>191</sup> Thus, the simplest preemption analysis occurs where Congress has expressly stated in the relevant legislation the application and extent of preemption, provided Congress is acting within its authority under the Constitution.<sup>192</sup> Generally, where there is no mention of preemption, federal law preempts conflicting state law.<sup>193</sup>

Preemption of state law also occurs when federal agencies, acting within their statutory authority, issue regulations that conflict with state law.<sup>194</sup> For example, in *Donmar Enterprises v. Southern National Bank*,<sup>195</sup> the issue was whether the Federal Reserve Board’s Regulation J preempted state law causes of action in cases involving wire transfers of funds.<sup>196</sup> The district court held that “under the Supremacy Clause,

---

186. U.S. CONST. art. VI, cl.2.

187. *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992) (quoting *Maryland v. Louisiana*, 451 U.S. 725, 746 (1981)).

188. *See id.*

189. *Id.* (citing *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977)).

190. *See, e.g.*, 29 U.S.C. § 1144(a) (1994) (stating that certain provisions of the Employee Retirement Income Security Act (ERISA) “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) of this title and not exempt under section 1003(b) of this title”).

191. “Congress’ intent to pre-empt all state law in a particular area may be inferred where the scheme of federal regulation is sufficiently comprehensive to make reasonable the inference that Congress ‘left no room’ for supplementary state regulation. *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230, 67 S. Ct. 1146, 1152, 91 L.Ed. 1447 (1947). Pre-emption of a whole field also will be inferred where the field is one in which ‘the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject.’ *Ibid.*” *Hillsborough County v. Automated Medical Lab., Inc.*, 471 U.S. 707, 713 (1985).

“Even where Congress has not completely displaced state regulation in a specific area, state law is nullified to the extent that it actually conflicts with federal law. Such a conflict arises when ‘compliance with both federal and state regulations is a physical impossibility,’ *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-143, 83 S. Ct. 1210, 1217-1218, 10 L.Ed.2d 248 (1963), or when state law ‘stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’” *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

192. *See City of New York v. FCC*, 486 U.S. 57, 63 (1988).

193. *See Cipollone*, 505 U.S. at 516; *Hillsborough County*, 471 U.S. at 713.

194. *See City of New York*, 486 U.S. at 63; *Hillsborough County*, 471 U.S. at 713 (“We have held repeatedly that state laws can be pre-empted by federal regulations as well as by federal statutes.”).

195. 828 F. Supp. 1230 (W.D.N.C. 1993).

196. *See id.* at 1234.

Regulation J . . . pre-empts all alternative causes of action—including negligence and wrongful payment—that are inconsistent with Regulation J.”<sup>197</sup> Similarly, in *Idaho v. Security Pacific Bank Idaho*,<sup>198</sup> the debate centered around whether the National Bank Act preempted a state law which prohibited national banks from operating on Saturdays.<sup>199</sup> In holding that federal law preempted state law, the court stated that since “Congress has not completely preempted the entire banking field . . . any preemption must arise out of an actual conflict between federal and state law.”<sup>200</sup>

B. *Extent of Preemption of U.C.C. § 4-209 by Regulation CC*

In 1987, Congress enacted the Expedited Funds Availability Act,<sup>201</sup> giving the Federal Reserve Board the authority to promulgate regulations “[i]n order to improve the check processing system.”<sup>202</sup> Under this mandate, the Federal Reserve Board enacted Regulation CC: Availability of Funds and Collection of Checks.<sup>203</sup> Regulation CC’s main purpose is to implement provisions of the Expedited Funds Availability Act.<sup>204</sup> Because the Expedited Funds Availability Act was enacted before revised section 4-209 of the UCC was drafted, there is no express indication in the Act of congressional intent to preempt state law on encoding warranties.<sup>205</sup> The Act does not deal with and thus does not conflict with state law encoding warranties. Moreover, there is no reason to believe that Congress left no room for state law on encoding warranties or that the federal interest in encoding warranties is so dominant that it must preclude enforcement of state laws on the same subject.<sup>206</sup> Thus, there would seem to be no congressional preemption of section 4-209 of the UCC.

Does Regulation CC totally preempt state law encoding warranties? Some commentators believe that Regulation CC acts largely as a “gap filler” for holes left open under the Uniform Commercial Code,<sup>207</sup> rather than acting to completely preempt all state law in this area. Under this

---

197. *Id.* at 1237.

198. 800 F. Supp. 922 (D. Idaho 1992).

199. *See id.* at 923.

200. *Id.* at 925.

201. 12 U.S.C. §§ 4001-4010 (1989).

202. 12 U.S.C. § 4008(b).

203. 12 C.F.R. pt. 229.

204. *See* 12 C.F.R. § 229.1(a) (1996).

205. The Act only expressly states an intent to preempt state law that permits a longer period of time than the Act permits for deposited funds to be made available to depositors. *See* 12 U.S.C. § 4007 (1987).

206. *See supra* note 191.

207. CLARK, *supra* note 33, ¶ 8.14.

view, Regulation CC preempts only those state provisions clearly in conflict with it, and imposes additional requirements on banking institutions.<sup>208</sup> Others believe the preemptive effect of Regulation CC is more pervasive, especially as it relates to the return process.<sup>209</sup>

Some evidence of the preemptive power of Regulation CC lies in the fact that the drafters of revised Article 4 abandoned efforts to improve the check return process once it was determined that Regulation CC contained related provisions.<sup>210</sup> Perhaps the drafters saved themselves some time in the end by deciding to forgo implementation of possibly preempted areas; however, some areas of revised Article 4 are still preempted.<sup>211</sup> Whether this includes section 4-209's encoding warranty remains an open question that the remainder of this Article will address.

Revised Article 4 makes some references to the possibility of preemption of some of its provisions by federal law. For example, comment 1 to section 4-102 states that federal law, specifically Regulation CC, may supersede provisions of revised Article 4.<sup>212</sup> In addition, comment 3 to section 4-103<sup>213</sup> expressly states that Regulation CC preempts any inconsistent provisions of revised Article 4.<sup>214</sup>

Regulation CC itself contains several sections touching upon the issue of preemption. For example, 12 C.F.R. § 229.20(b)<sup>215</sup> provides as follows: "Except as provided in paragraph (a), the Act and Subpart B [of Regulation CC], and, in connection therewith, Subpart A, supersede any provision of inconsistent state law."<sup>216</sup> In addition, 12 C.F.R. § 229.41, which is contained in Subpart C of Regulation CC (Collection of Checks) along with Regulation CC's encoding warranty, contains substantially the same provision.<sup>217</sup> The Official Commentary to 12

---

208. *See id.*

209. *See* Lawrence, *supra* note 152, at 28. Professor Lawrence maintains that as for check returns and funds availability, Regulation CC preempts all state law; as for forward collection and final payment, these areas are covered under revised article 4 "at least until the Fed decides to preempt these areas." *Id.*

210. *See* Lawrence, *supra* note 152, at 32.

211. For example, the concept under article 4 that payment is not final until the midnight deadline (U.C.C. § 4-215) is preempted by Regulation CC Section 229.36(d), which makes all settlements between banks in the forward collection process final when made. *See* U.C.C. § 4-215, cmt. 4 (1990). However, the paying bank's right to return the check before its midnight deadline under the UCC is not affected by Regulation CC. *See id.* § 4-303, cmt. 4.

212. *See* U.C.C. § 4-102, cmt. 1 (1990).

213. Section 4-103 discusses the effect of Federal Reserve regulations and operating circulars on agreements between parties under article 4. *See id.* § 4-103.

214. *See id.* § 4-103, cmt. 3.

215. This section is under Subpart B of Regulation CC, entitled "Availability of Funds and Disclosure of Funds Availability Schedules."

216. 12 C.F.R. § 229.20(b) (1996).

217. *See* 12 C.F.R. § 229.41.



C.F.R. § 229.41 states that "this regulation is not a complete replacement for state laws relating to the collection of checks."<sup>218</sup> Therefore, the expressed intent of the Federal Reserve Board is to preempt only inconsistent provisions of state law; areas of Article 4 which do not conflict with Regulation CC remain intact.

The Official Commentary to Regulation CC provides more insight into the preemptive effect of 12 C.F.R. § 229.34(c). The comments state that Regulation CC's encoding warranty "expands" upon the UCC by making the warranty applicable to all banks in the chain and to return items.<sup>219</sup> If the Federal Reserve Board had intended totally to preempt the UCC's encoding warranty, it had a perfect opportunity to incorporate that intention in the commentary. By using the word "expands," the Federal Reserve Board, by its own language, undoubtedly leaves some, if not all, of section 4-209 intact.

Commentary in the *Federal Register* during the rule-making process also proves helpful in the preemption analysis. The encoding warranty, as originally proposed by the Federal Reserve Board, did not include a warranty as to the accuracy of the encoding amount.<sup>220</sup> The Board stated that because section 4-209 of the UCC contains such a warranty, in the states that have adopted the 1990 revisions to article 4, "the encoding banks would make warranties to cover encoding accuracy and these warranties would extend to all of the banks that subsequently handle the check."<sup>221</sup> However, after the Board solicited comments to the proposed regulation, twenty commentators requested the incorporation of the UCC encoding warranty "to ensure consistent rights for all payments system participants."<sup>222</sup> The Board subsequently adopted a "modified version" of section 4-209. This modified version of section 4-209 extends the benefit of the warranty from the encoding bank to *any* transferring bank in either the forward collection process or the return process.<sup>223</sup> The Board stated that it modified the regulation to "facilitate the making of warranty claims by permitting them to be made against the presenting bank and then passed back up the collection chain, much in the same manner as other warranties under the UCC."<sup>224</sup>

---

218. 12 C.F.R. pt. 229, app. E, at 534.

219. *Id.* at 523. Another way in which Regulation CC's encoding warranty expands upon the UCC is by providing a right of setoff in the regulation itself which allows the paying bank to setoff amounts owed by a presenting bank (due to previous overencoding errors) against future settlement payments to that presenting bank. See 57 Fed. Reg. 46,966 (1992); see also *supra* Part III.E.

220. See 57 Fed. Reg. 46,965 (1992).

221. *Id.*

222. 57 Fed. Reg. 46,966 (1992).

223. See *id.*

224. *Id.*

Given the Official Commentary to Regulation CC and the commentary found in the *Federal Register*, it appears that the Federal Reserve Board did not intend for Regulation CC to completely preempt Article 4. So what portions, if any, of section 4-209 are preempted by Regulation CC or, to put the question another way, what is left of section 4-209 after Regulation CC was amended?

One obvious, though only partial, answer to this question deals with non-banking entities who do their own encoding. The UCC's encoding warranty applies to any "person" who encodes information on a check.<sup>225</sup> Applicability of Regulation CC, however, is limited to banking institutions.<sup>226</sup> Therefore, non-banking entities who do their own encoding only make warranties under section 4-209, not Regulation CC.

The more difficult question involves banks who encode. This situation is covered by both the UCC encoding warranty and Regulation CC. Preemption is a significant issue in this situation because, in cases of overencoding, the damages provision of section 4-209 is potentially more generous than the damages recoverable under Regulation CC.<sup>227</sup> Since there is no intent by Congress<sup>228</sup> or the Federal Reserve Board<sup>229</sup> to preempt section 4-209 of the UCC completely, the question becomes: To what extent is there actual conflict between the damages provisions of Regulation CC and the damages provisions of section 4-209 of the UCC?<sup>230</sup>

The best answer is that there is in fact no conflict—at least where consequential damages are concerned. Regulation CC limits damages to the amount of the item plus interest and incidental damages.<sup>231</sup> This is because recovery of the difference between the overencoded amount and the true amount of a check is permitted through setoff by the injured bank without litigation and because both the encoding party and intermediary banks make the Regulation CC encoding warranty. Damages under Regulation CC must be limited to those amounts which are obvious, easy to calculate, and subject to little or no dispute for setoff against future items presented for payment to be appropriate and for intermediary collecting banks to be liable in warranty for acts of the misencoding bank. Furthermore, the damages must exclude consequential damages, since recovery is permitted against intermediary banks which did not

---

225. U.C.C. § 4-209(a) (1990).

226. See 12 C.F.R. § 229.1 (1996) (explaining the purpose of Regulation CC).

227. See *supra* Parts II.D, III.D.

228. See *supra* notes 205-06 and accompanying text.

229. See *supra* notes 215-24 and accompanying text.

230. See *supra* note 193 and accompanying text; see also *supra* note 200 and accompanying text.

231. See 12 C.F.R. § 229.34(d).

actually do the misencoding. Otherwise the disruption to the item collection process could be extreme.

Section 4-209 of the UCC provides for recovery of consequential damages because it contemplates a litigation process for such recovery, not setoff. There is no conflict, because Regulation CC does not prohibit or deal with recovery of consequential damages through litigation, only through setoff. The state statute and federal regulation can coexist and complement each other without conflict if recovery for breach of warranty is permitted to include consequential damages under section 4-209 (where they must be established in litigation) and limited as indicated under Regulation CC (where recovery is through setoff). Such a construction provides an adequate remedy in those (hopefully rare) cases of overencoding and resulting wrongful dishonor that subject the payor bank to liability to its customer substantially beyond the face amount of the check. If the consequential damages provision of section 4-209 does not survive Regulation CC, the payor bank may be left with a substantial loss which should instead fall on the encoding bank or entity which actually caused the loss.<sup>232</sup> Neither the language, goals, nor operation of Regulation CC require this result.

---

232. Cf. *Girard Bank v. Mount Holly State Bank*, 474 F. Supp. 1225 (D.C.N.J. 1979) (mentioning the UCC policy favoring deterrence of the actor best able to prevent the fraud).